United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

75 6111

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 75-6111

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P/S

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

v.

UNIVERSAL MAJOR INDUSTRIES CORPORATION, JAMES G. DUNCAN, TRANSAMERICAN PETROLEUM CORPORATION, ROY M. HORSEY, BANNER OIL AND GAS FUNDS, INC., IAN McCARTNEY, ARTHUR J. HOMANS, AND EDWARD G. GEDALECIA,

Defendants,

ARTHUR J. HOMANS,

Defendant-Appellant.

On Appeal from the Judgment of the
United States District Court for the
Southern District of New York

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, APPELLEE

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UNITED STATES COURT OF APPEALS
FILED
SEP 22 1976
A. DANIEL FUSARO, CLERK
SECOND CIRCUIT

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COUNTERSTATEMENT OF THE QUESTION PRESENTED

1. When, in reliance on the "private offering" exemption from registration contained in Section 4(2) of the Securities Act of 1933, counsel for a corporation instructed its transfer agent in over two hundred letters over a four-year period to issue a total of over three million shares of the corporation's stock to over a thousand purchasers, stating either (1) that he was relying on an opinion of other counsel that the requested issuance of unregistered shares did not constitute a violation of the Act or (2) that it was his opinion that the issuance of the unregistered shares was not in violation of the Securites

Act of 1933, and when counsel did not know most of the persons who were to receive the stock nor what knowledge they had of the corporation, may he be enjoined from participating in future violations of the Securities Act?

COUNTERSTATEMENT OF THE CASE

This is an appeal by Arthur J. Homans from an order entered by the United States District Court for the Southern District of New York permanently enjoining him from engaging in acts or practices that violate or aid and abet violations of Section 5 of the Securities Act of 1933, 15 U.S.C. 77e, based on findings that he participated in unregistered sales of common stock of Universal Major Industries Corporation ("UMI") (A. 176). 1/

In its complaint, the Commission had alleged that UMI, Transamerica Petroleum Corporation, Banner Oil and Gas Funds, Inc., and Messrs. Homans, Gedalecia, Duncan, Horsey and McCartney had violated Section 5 of the Securities Act of 1933 in connection with the offer and sale of the common stock of UMI. 2/ Messrs. Duncan, Horsey and McCartney, as well as UMI, also were charged with violations of the antifraud provisions of the federal securities laws in connection with those sales (A. 11-12).

Except for Mr. Homans, the defendants consented to the entry of orders of permanent injunction against them (A. 137). Thus, the proceedings below

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1/ On April 30, 1976, this Court granted Mr. Homan's motion to proceed on the original record. Consequently, counsel for the Commission made no designation of the record. Mr. Homans, however, has filed an appendix with his brief in this Court. Pages in that appendix are cited as "A. ___." Material in that appendix will be referred to as "Tr. __" for pages of the transcript; "Def. Ex. __" for pages of defendant's exhibits; and "Pl. Ex. __" for pages of exhibits introduced by the Commission.

2/ While there also appear to have been violations of the registration provisions of the Securities Act in connection with the offering of UMI's debentures, see p. 6, infra, the Commission did not charge these violations in its complaint.

related to the Commission's allegations that Mr. Homans, who had served as counsel to UMI during the relevant periods, had aided and abetted violations of Section 5 of the Securities Act of 1933. 3/

FACTS

A. Background

UMI is a Nevada corporation 4/ with its principal place of business in New York. Between 1959 and 1966 UMI was controlled by Leonard Ashbach, and was engaged in the distribution of electronic products and motorcycles (Tr. 159). In August 1966, James G. Duncan conveyed all of his stock interest in Duncan Oil and Chemical Corporation to UMI in return for 313,333 shares of UMI common stock (Def. Exh. M). As a result of that transaction, Messrs. Duncan and Ashbach jointly controlled UMI, having equal voting control (Tr. 159). UMI's principal activity gradually became the exploration and development of oil and gas properties. In March 1967, Mr. Ashbach sold his equity interest in UMI to a group headed by Roy M. Horsey (Tr. 160). The Horsey group became responsible for the day-to-day management of UMI until May 1968, when Mr. Duncan assumed that role.

3/ Hearings on the Commission's request for a preliminary injunction against Mr. Homans were held on a number of dates in 1973 and in 1974. On the date of the last hearing, the district court granted the Commission's motion to consolidate the hearing on the preliminary injunction with the hearing on the permanent injunction pursuant to Rule 65 of the Federal Rules of Civil Procedure (A. 177, n. 3).

4/ UMI was incorporated in 1954 pursuant to the laws of the State of Nevada under the name of Universal Major Corporation. Its name was changed to Universal Major Industries Corporation on October 3, 1966, as a result of an agreement of merger with Inland Resources Corporation (Def. Ex. L).

Mr. Homans, who had been a personal friend of Leonard Ashbach for a long period of time, first became associated with UMI, as corporate counsel, in 1959 (Tr. 161). In that capacity, he advised UMI on securities law questions as well as on general corporate matters. Mr. Homans continued as corporate or general counsel to UMI after the change in management (Tr. 407-408), and until his resignation in January, 1973 (Tr. 212).

Although Mr. Homans had some responsibility for securities matters, the board of directors of UMI, in October, 1967, retained a special securities counsel, Edward Gedalecia, and his firm, to prepare and file a registration statement with the Commission covering the issuance of UMI securities (Def. Ex. E). 5/ Mr. Gedalecia was to be responsible for the securities law questions relating to that registration statement; to the extent that Mr. Homans rendered securities advice, he was to charge UMI on a per diem basis. 6/

5/ The minute of the board of directors meeting stated (Def. Ex. E, p. 2):

> "RESOLVED, that the President of the Company be and hereby is authorized to retain Messrs. Edward J. Gedalecia and Murray J. Chikofsky as attorneys to undertake the filing of a registration statement on behalf of the Corporation with the Securities and Exchange Commission. . . ."

The registration statement was to cover "the issuance of a 6% subordinate convertible debenture in the aggregate sum of $10,000,000 to be exchanged for the present outstanding debentures and to be used for the acquisition of such other oil and gas interest and other properties as the Company may determine to acquire" (Def. Ex. E, at pp. 3-4). The registration statement would necessarily have to cover, as well, the common stock into which the debentures were convertible. As a matter of fact, when a registration statement prepared by Mr. Gedalecia was subsequently filed with the Commission in March 1971, it dealt only with common stock. That registration statement never became effective (Def. Ex. L and M; Pl. Ex. 2).

6/ Although Mr. Homans continued to render advice on securities matters, he never claimed per diem pay for the advice he rendered in connection with UMI's securities activities, because he considered that to be part of his job as corporate counsel (Tr. 450).

B. UMI's Securities Transactions

Prior to the time Mr. Gedalecia was retained, the UMI board of directors authorized, in March, 1967, a private offering of 6 percent convertible debentures in the face amount of $3 million. Of these Mr. Duncan received debentures in the face amount of $750,000, as consideration for certain participation interests in oil and gas wells that he had transferred to UMI (Tr. 162).

In connection with the offering, it was Mr. Homans' opinion that registration of the debentures was not required under the Securities Act of 1933 so long as the debentures were offered to only a limited number of persons who would receive adequate financial and other information concerning UMI's operations (A. 163). Mr. Homans was informed that these restrictions would be followed strictly (id.).

Shortly after the offering began, however, Mr. Homans was advised by certain officers of UMI that the number of individuals who had purchased these 6 percent debentures was far in excess of what he had been led to believe (A. 166-167). In this connection he learned that UMI was using the debentures to pay individuals who had sold UMI fractional interests in oil and gas wells in fields in which UMI previously had acquired interests from Mr. Duncan (Pl. Ex. 13). Between April 1967 and December 1968, UMI issued debentures in the face amount of $3,411,125 to approximately 425 persons. Upon learning these facts Mr. Homans concedes that he concluded that the debentures should have been registered pursuant to the Securities Act of 1933 because "as a securities lawyer [he knew] that such a debenture if issued to more than a minimal number of people would require registration" (Tr. 171-172).

After having issued almost $3.5 million worth of 6 percent debentures, as well as nearly $440,000 worth of 7 percent debentures during the same period, UMI had difficulties in meeting its interest obligations on these debentures (Tr. 280). In order to alleviate this problem, between May of 1968 and May of 1972, UMI persuaded debenture holders that they convert their debentures to common stock in UMI or accept common stock in lieu of cash as payment for interest (Def. Ex. M). As a direct result of UMI's efforts, approximately 1.1 million shares of UMI common stock were issued to 262 debenture holders who converted their debentures (Pl. Ex. 1). An additional 270,000 shares of UMI common stock were distributed during the period to 489 debenture holders in lieu of cash for interest payments (id.). UMI also issued almost 840,000 shares of its common stock to 94 persons in exchange for cash, services or oil and gas properties (id.). Neither these shares, nor the shares issued to debenture holders, were registered with the Commission (Pl. Ex. 2, Def. Ex. L and M).

In addition to the 2.2 million unregistered shares of its common stock distributed by UMI, individuals associated with UMI and certain related companies distributed another 595,000 shares. Thus, Duncan sold 345,000 shares to 59 investors, Horsey sold approximately 190,000 shares to 74 investors, and Transamerican Petroleum Corporation, a corporation controlled by Duncan (A. 13), sold 60,000 shares to 36 investors (Pl. Ex. 13). 7/

A total of 3,219,884 unregistered shares were distributed by UMI and related persons during the period May 1968 to May 1972 to 1014 individuals (Pl. Ex. 13).

7/ UMI also issued approximately 470,000 shares of common stock to 48 individuals for conversion of their interests in Banner Oil and Gas Funds, Inc., a wholly owned subsidiary of UMI (Pl. Ex. 1).

C. Mr. Homans' Role in UMI's Common Stock Transactions

1. The stock transfer letters

In his capacity as corporate counsel to UMI, Mr. Homans wrote a total of 206 letters instructing the Continental Stock Transfer Corporation to transfer UMI common stock to specified individuals in connection with:

(1) the conversion of UMI's 6 and 7 percent debentures;

(2) the payment of interest on those debentures with common stock in lieu of cash;

(3) the payment to individuals in exchange for cash, services, or oil or gas properties;

(4) the transfers made by Messrs. Duncan and Horsey, and Transamerican Petroleum Corporation.

Of these letters, 118 related to conversions of debentures or the payment of common stock as interest on debentures (Pl. Ex. 13). These will be referred to as "Type I" letters. The remaining 88 letters were written with respect to the issuance of shares to pay for services or properties or in connection with the transfers made by the insiders of UMI (Pl. Ex. 13). These will be referred to as "Type II" letters.

The Type I letters instructed the transfer agent to issue UMI common stock in accordance with instructions of the management of UMI that were attached to each letter. Because the securities to be issued were unregistered, Mr. Homans also attached an opinion from Mr. Gedalecia's law firm which stated, with respect to the legality of issuing the unregistered securities, that:

> "In view of the fact that the debentures and the underlying stock into which they are convertible were, in our opinion, sold in transactions violative of Section 5 of the Securities Act of 1933 . . . the conversions at this time, as proposed, would not constitute additional violations of the Act" (Pl. Ex. 3).

In his cover letter Mr. Homans stated that he was relying on this "opinion," which he characterized as stating that the conversion of the debentures "does not constitute a violation of the Securities Act" (Pl. Ex. 3). Mr. Gedalecia's opinion, however, stated only that the conversion and issuance of common stock would not constitute "additional violations" of the Securities Act in light of the fact that the original issuance of the debentures had been in violation of that Act, suggesting that it would be a continuation of the original violations; it did not state, as Mr. Homans suggested in his cover letter, that the issuance of the common stock would be in conformity with the requirements of the Securities Act.

In the Type II letters to the transfer agent by which 1,836,226 shares of UMI stock were issued to 23 individuals (Pl. Ex. 13), Mr. Homans did not "rely" on the opinion of any other person concerning the legality of the issuance of the unregistered common stock (Pl. Ex. 6). Those letters typically stated:

> "I am counsel to Universal and I submit the following opinion to you. I have examined the minute books of the corporation and other relevant documents and on the basis of the foregoing, it is my opinion that the issuance of these . . . shares have been duly approved as required by law; and that all appropriate action necessary for the issuance of such shares has been taken. It is therefore my opinion that such shares, when issued, will be regularly issued, fully paid and non-assessable.
>
> You are further advised that these shares have not been registered under the Securities Act of 1933. Therefore, you are requested to place an appropriate notation to the effect that further transfer of these shares is restricted except under applicable rules and regulations of the Securities and Exchange Commission. You are further requested to place an appropriate legend on the certificates themselves to the same effect.
>
> You are further advised that the corporation has received from the persons named so called 'investment letters' in form approved by the undersigned, to the effect that they are acquiring the said shares for investment only and not for public sale or distribution.

> It is my opinion therefore that the issuance of such shares is not in violation of the Securities Act of 1933, nor of the rules and regulations of the Securities and Exchange Commission." (Emphasis supplied.)

Thus, these Type II letters reflect Mr. Homans' opinion, as counsel to UMI, that common stock that was not registered could be released by the transfer agent. Pursuant to the contract between UMI and Continental Transfer, at least two documents were required by Continental before it would release UMI common stock. One was an authorization of UMI to release the stock indicating the number of shares and the transferee; the second document was an opinion from the general counsel of UMI to the effect that the transfer was lawful (Tr. 139). Without such an opinion, which requirement was designed to assure that UMI's counsel was aware of, and approved, all stock transfers, Continental would not effect the transfer (Tr. 141-142). Thus, notwithstanding that Mr. Gedalecia was retained by UMI to prepare a registration statement for a particular offering, he could not effect the transfer of UMI stock himself. The agreement named Mr. Homans as the individual at UMI who was to authorize the transfer of stock; no action was ever taken by UMI to substitute Mr. Gedalecia for Mr. Homans in connection with that function (Tr. 435).

2. The recipients of UMI stock.

Although some of the individuals who received UMI common stock during the period it was being offered for a variety of purposes can be considered "insiders" of UMI -- management personnel or control persons -- other recipients had little, if any, relationship with UMI, save for their stock

interests. This is demonstrated by the testimony of Messrs. Nardone and Andersen, two investors in unregistered UMI common stock. 8/ Mr. Nardone purchased 5,000 shares of unregistered UMI common stock at $1 per share. At the time of his purchase, he was employed by the Board of Education of the City of New York as a carpenter foreman and earning $14,000 a year (Tr. 51-52). He had no connection whatsoever with UMI, nor any intimate knowledge of UMI's operations (Tr. 55-56). 9/

Mr. Nardone was not advised by UMI or Mr. Homans as to the length of time he would have to hold the UMI securities (Tr. 57); and although he signed an investment letter form, he "had never seen something like that before" and did not understand it (Tr. 55). In short, Nardone was not given access to the kind of information concerning UMI that would be available in a registration statement under the Securities Act, nor was he the kind of individual who could fend for himself in acquiring and understanding relevant information concerning UMI. Notwithstanding that he did not have any idea as to the kind or amount of information Mr. Nardone had been given before purchasing UMI stock (Tr. 424), Mr. Homans rendered his opinion that the sale was in conformity with the Securities Act of 1933.

8/ The stock issued to Mr. Nardone was transferred from Mr. Duncan pursuant to instructions and a legal opinion by Mr. Homans (Def. Ex. C). Mr. Andersen's stock was transferred directly from UMI and also was the subject of a legal opinion by Mr. Homans (Pl. Ex. 17).

9/ While Mr. Nardone did attend the 1970 and 1971 annual shareholders meetings of UMI, he did not understand the charts that were displayed at the meetings (Tr. 88).

Mr. Andersen purchased 1500 shares. At the time of his purchase he was an architectural designer and had no conection with UMI; he became familiar with UMI through Ian McCartney, a UMI employee. Mr. Andersen testified that he purchased 1,500 UMI shares because he "trusted" Mr. McCartney (Tr. 124-126). Mr. Andersen was not given access to information concerning UMI of the kind that the Securities Act would make available in the form of a registration statement, nor was he particularly knowledgeable about UMI's business activities (Tr. 125-127). As in the case of Mr. Nardone, Mr. Homans did not know what information concerning UMI had been furnished to Mr. Andersen prior to his purchase (Tr. 424).

In writing opinion letters authorizing the issuance of unregistered UMI stock, Mr. Homans did not make any determination as to whether the particular investors had received any meaningful information from UMI and, even if they had, whether they could fend for themselves absent registration. Instead, he relied solely on (1) the investment letter signed by the investor; 10/ (2) the representations by UMI management that the particular transaction was private; or (3) the fact that the transaction was one relating to an exchange of working interests in the oil and gas wells which Duncan had sold to numerous investors prior to 1966 (Tr. 197, 231-32, 350, 448-49).

Mr. Homans stated that he had given Messrs. Duncan and Horsey guidelines as to the procedures to be followed with respect to securities transactions involving unregistered securities (Tr. 425). According to

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10/ In discussing one of the investors in UMI, Leon Leonidoff, who was a choreographer at Radio City Music Hall, Mr. Homans testified that he did not know "whether he [Leonidoff] was sophisticated or unsophisticated, but like everyone else, he signed an investment letter. . . " (Tr. 262).

Mr. Homans, these guidelines specified that UMI should furnish "whatever financial information a prospective investor or transferee should require . . . to be circumspect in the type of person that they would be dealing with as to the nature of the individual, whether he would be a sophisticated person, whether he would know what he was doing when he was going into an investment of this character, and that he would know that he was receiving restricted stock" (Tr. 425-426).

Mr. Homans also stated that he would not issue an opinion to the transfer agent that a transaction was exempt under either Section 4(1) or Section 4(2) of the Securities Act of 1933 11/ unless he had received (1) an instruction letter from UMI authorizing the issuance of the stock in exchange for working interests or fractional interests in oil or gas properties or stating that the transaction was a private transaction; and (2) an "accompanying letter of investment representation by the transferee." (A. 100, Pl. Ex. 9A).

Mr. Homans assumed that if the management of UMI authorized a stock transfer in writing, they had complied fully with his guidelines and that the transaction, therefore, was a private transaction (A. 101, Br. 18). If the authorization reflected that the stock was to be transferred in exchange

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11/ Section 4(1) provides: "The provisions of Section 5 shall not apply to . . . (1) transactions by any person other than an issuer, underwriter, or dealer."

Section 4(2) provides: "The provisions of Section 5 shall not apply to . . . (2) transactions by an issuer not involving any public offering."

for interests in oil or gas properties, Mr. Homans considered the transferees to be sophisticated investors because, in his view, all individuals who invest in oil and gas ventures are sophisticated persons (Tr. 394, 466). 12/

Mr. Homans, however, had no knowledge as to whether Messrs. Duncan or Horsey ever told any of the investors of the risk factors involved in investing in UMI (Tr. 464), and while Mr. Homans told Messrs. Horsey and Duncan to furnish to prospective investors whatever financial information such investors required (Tr. 425-26), he took no steps to insure that his instructions were being followed by the management of UMI (A. 101).

Moreover, in most instances, the purchasers were total strangers to him (Tr. 196-200, 414-23) and (1) he did not know whether all the investors were knowledgeable of UMI's operations or were experienced in investments of this types (Tr. 440-41); (2) he failed to inquire of UMI's management as to how many offers were made to other persons -- those who did not purchase UMI securities but were solicited by UMI to purchase its securities (Tr. 436-37); and (3) he failed to inquire of UMI's management whether they were utilizing their employees to solicit individuals to purchase UMI securities (Tr. 439). This last fact he testified he did not learn until he subsequently "began to investigate [his] . . . files. . ." (Tr. 439).

D. The District Court's Opinion

Based on the facts before it the district court concluded that the distribution of nearly 3.5 million shares of unregistered UMI common stock violated the registration requirements of the Securities Act; that Mr. Homans

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12/ Mr. Homans also is of the view that a speculator in securities is a sophisticated person who would qualify for a private placement (Tr. 441).

aided and abetted those violations through the issuance of opinion letters asserting the legality of those transactions when he knew or should have known that they were illegal; and that injunctive relief against Mr. Homans was appropriate in light of the facts found by the court.

With respect to the private offering exemption from registration in Section 4(2) of the Securities Act, the district court found that while some transfers of unregistered common stock were made to persons associated with UMI, "the record of sales and exchanges of common stock for value is dotted throughout with the names of persons whose relationship with UMI and whose ability to fend for themselves could only be termed 'minimal'" (footnote omitted) (A. 166). The court pointed out that the exemption from registration may not be available, even if an offer or sale is made to only a limited number of persons who indicate that they are purchasing for investment only, if such persons cannot "fend" for themselves. The district court stated (A. 162-63) that it is

> "crystal clear that it is not the manner in which a sale of unregistered securities is effected, but rather the class of persons to whom such securities are offered which determines whether the Section 4(2) exemption is available" (emphasis in original).

The court noted that once the Commission had made out a prima facie violation of Section 5 by showing that securities were sold in interstate commerce that were not registered, the burden of establishing the availability of an exemption was on Mr. Homans, and that he had failed to sustain his burden. The court pointed out that Mr. Homans did not show that UMI common stock had not been offered to more than the persons who ultimately purchased but the record suggested that to have been the case (A. 165). In any event, Mr. Homans "failed to establish

that all of those who purchased UMI common stock or received stock for value belonged to a class of persons who could 'fend' for themselves" (emphasis in original) (A. 165). 13/

Finally, the court held that Mr. Homans had failed to establish that "those who received UMI common stock for value either obtained automatically, or had access to, the sort of information which UMI would have been compelled to disclose had it filed a registration statement" (A. 166-167). Indeed, the court noted "Homans admitted that he had never instructed UMI management to make such information available" and he did not offer any evidence as to the kind of information that typically was given to recipients (A. 167). Under all of these circumstances, the district court held that the Section 4(2) "private offering" exemption was not available. 14/

The district court concluded that Mr. Homans had aided and abetted the violations of Section 5 because he knew or should have known that the 206 letters he had written to UMI's transfer agent directly facilitated the illegal distribution of UMI common stock. The court rejected Mr. Homans' argument that the Type I and Type II letters authored merely were "transmittal letters" for the legal opinion of Mr. Gedalecia (the Type I letters only) and the instructions from UMI to the transfer agent.

> "To classify either form letter as a 'transmittal letter' is an understatement. The . . . [Type II] letters speak for themselves. The fact that such letters were written under Gedalecia's direction

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13/ Mr. Homans testified that although he had the opportunity, from time to time, to meet prospective transferees, it was not his regular practice to look behind any of the representations made to him (Tr. 398, see also A. 153).

14/ Although Mr. Homans also had asserted that the transactions were exempt pursuant to Sections 3(a)(9) and 4(1) of the Securities Act, 15 U.S.C. 77c(a)(9) and 77d(1), the district court found that he did not sustain his burden of establishing the applicability of those sections (A. 161-162).

> does not negate the conclusion that any third party receiving such a letter would have reasonably concluded that Homans, as an attorney, was expressing his own opinion as to the legality under the Act of a particular issuance or transfer of stock.
>
> The . . . [Type I] letters, similarly, could reasonably have been understood as expressing an opinion, albeit one made 'in reliance upon' another's opinion, as to the legality of the issuances they covered. If, as Homans contends, such letters were merely intended to serve as 'transmittal letters,' it is difficult to understand why such letters were written on Homans' stationary (or, indeed, why Homans, an attorney, wrote any such letters), why such letters directed the issuance of restricted and appropriately legended stock, and why such letters contained a statement indicating that Homans relied upon the opinion of another" (emphasis in original) (A. 149).

Moreover, the court found Mr. Homans' argument that he had no reason to know that an illegal distribution was taking place to be meritless. The court held that "in some circumstances Homans knew, and in other circumstances, had reason to know that his client was engaging in illegal distributions of its common stock and that his letters were being used to further those distributions" (A. 156). In this connection the court pointed out that, in 1967, Mr. Homans had discovered that UMI distribution of debentures was in probable violation of the Securities Act and that when he advised UMI management of his views, they promptly retained Mr. Geladecia to prepare and file a registration statement for another debenture offering (A. 157). In light of these facts, the district court found that "Homans was clearly on notice as of October, 1967, that his client could not be trusted in matters involving the distribution of securities" (A. 157).

The court also noted that Mr. Homans had told UMI management that he would not issue any opinion concerning the legality of the distributions of common stock in conversion of the debentures or as payment of interest on the debentures and insisted that UMI obtain the opinion of other counsel

(A. 157-158). Had he not considered these distributions of common stock to be illegal, the district court found it difficult to understand why he demanded the opinion of another counsel.

> "That . . . [Mr. Homans] knew he might be held liable for aiding an illegal distribution is buttressed by the fact that, although Homans blithely issued . . . [Type II] letters regarding the legality under the Securities Act of other transfers of UMI stock, he specifically used the [Type I] letter when asked to communicate with Continental regarding the issuance of stock upon conversion of or in lieu of cash interst upon the debentures" (A. 156).

Even if Mr. Homans did not have direct knowledge of the illegal distribution, in light of what he knew about his clients' lack of compliance with the federal securities laws, his failure to investigate representations made to him by UMI management was, the court found, at best, unreasonable (A. 158). The court stated (A. 172):

> "had Homans exercised due diligence -- had he made a thorough investigation of the representations being made to him -- he would have known that the transactions upon which he was being asked to furnish an opinion for Continental also involved illegal distributions of unregistered securities. In view of the notice he had as of late 1967 or early 1968 as to the inherent problem of relying upon his client and Gedalecia, it was reckless for him not to have looked behind the representations before directing that Continental transfer the stock in question."

Indeed, the court noted that Mr. Homans' policy of relying upon the representations made to him without any investigation might be viewed "as a calculated attempt to avoid liability. . ." (A. 158).

Having found that the Commission had made a prima facie showing of violations of the federal securities laws, and that there existed a reasonable likelihood of future violations by Mr. Homans, the district court granted the Commission's request for injunctive relief. In finding that there was

a reasonable likelihood of future violations the court noted that "the acts for which defendant has been found liable were carried out either with knowledge or reckless disregard of the truth" and that he had committed many, as opposed to a few isolated, transactions over a five or six year period (A. 175).

Furthermore, the court noted that Mr. Homans continued to represent four public companies and expected to render opinions in the future concerning matters under the federal securities laws. The court concluded that "Homans' contention that his acts were 'merely careless' and that, in view of the circumstances -- his relationship with UMI management and the retention of Gedalecia -- his acts were quite reasonable, as well as his 'ignorance' of the most basic principles of the Securities Act, make it difficult for this Court to conclude that he now appreciates the lawyer's duties when rendering opinion letters, such that he would probably not repeat his mistakes" (A. 175-176). 15/

STATUTE INVOLVED

Sections 4(2) and 5(a) of the Securities Act of 1933, 15 U.S.C. 77d(2) and 15 U.S.C. 77e(a) are set forth in the Statutory Appendix to this brief, infra.

15/ Pursuant to a motion filed by Mr. Homans on July 30, 1975, Judge Tenney conducted a hearing on August 12, 1975, to consider a proposal by Mr. Homans that a limited form of injunctive relief be entered against him. The court had already rendered its opinion concerning Mr. Homans' liability and the necessity for the issuance of an injunction. After hearing Mr. Homans' proposal the court decided that the form of the injunction requested by the Commission was appropriate. See discussion, pp. 39-40, infra.

ARGUMENT

I. THE DISTRICT COURT CORRECTLY CONCLUDED THAT UMI COMMON STOCK WAS SOLD IN VIOLATION OF SECTION 5 OF THE SECURITIES ACT OF 1933.

The district court found that Mr. Homans had aided and abetted the illegal distribution of over three million shares of UMI common stock to over 600 individuals (A. 138, A. 178, n. 9). Mr. Homans' primary contention in this Court is that each transaction for which he provided an opinion letter must be viewed as a single, isolated transaction exempt from the registration requirements pursuant to Section 4(2) of the Securities Act 16/ and not as part of a larger, "public" offering. Viewed in this fashion, Mr. Homans would have this Court hold that he had engaged in 206 private offerings involving three million shares of UMI common stock over a four year period. He offered no evidence to support his contention that these transactions must be viewed separately; he merely asserts that the Commission must prove a public offering. We submit that Mr. Homans' perception of where the burden lies is mistaken.

The basic statutory scheme of the Securities Act contemplates that every transaction involving the offer or sale of securities through the use of instrumentalities of interstate commerce or of the mails must be accompanied by the protections afforded by registration of the securities with the Commission and delivery of a statutory prospectus containing such information about the securities and the issuer as would enable a prospective investor to make an informed investment decision. 17/ Thus, Section 5(c) of the Securities Act prohibits "any person, directly or indirectly" from

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16/ That Section provides that the registration requirements of Section 5 do not apply to "transactions by an issuer not involving any public offering."

17/ "[E]very security and transaction not specifically exempt by the terms of the [Securities Act] should be kept within its scope." H.R. Rep. No. 85, 73d Cong., 1st Sess. 6-7 (1933).

offering to sell securities unless a registration statement has bee.. filed with the Commission, and Section 5(a) of the Act prohibits "any person, directly or indirectly" from selling securities unless a registration statement is in effect.

Mr. Homans does not dispute that no registration statement ever became effective with respect to UMI's common stock 18/ and that no registration statement has ever been filed or in effect with respect to UMI's 6% and 7% debentures. Nor is there any dispute that the instrumentalities of interstate commerce and the mails were employed in connection with these transactions. Thus, the Commission's uncontroverted evidence of the offer and sale of UMI's unregistered common stock clearly established a prima facie case of Securities Act violations. Securities and Exchange Commission v. Continental Tobacco Company of South Carolina, Inc., 463 F.2d 137 (C.A. 5, 1972); Hill York Corp. v. American International Franchises, Inc., 448 F.2d 680 (C.A. 5, 1971).

Mr. Homans asserts (Br. 50) that UMI's offers and sales of its unregistered common stock were exempt from registration pursuant to Section 4(2) of the Securities Act, 15 U.S.C. 77d(2). 19/ The Supreme Court, 20/ this Court, 21/

18/ As noted at p. 5, n. 5, supra, UMI did file a registration statement with the Commission prepared by Mr. Gedalecia with respect to its common stock in March 1971, but that registration statement never became effective.

19/ As noted, Mr. Homans also relied in the district court on Sections 3(a)(9) and 4(1) of the Securities Act in arguing that the transactions in issue were exempt from registration. The district court rejected these arguments and Mr. Homans has not raised them in this Court.

20/ E.g., Securities and Exchange Commission v. Ralston Purina Co., 346 U.S. 119, 126 (1953). Cf., also Edwards v. United States, 312 U.S. 473,482-483 (1941), which held that a criminal indictment which charges the sale of unregistered securities is valid without charging that they are not of an exempted class.

21/ E.g., Securities and Exchange Commission v. Culpepper, 270 F.2d 241, 246 (C.A. 2, 1959); Gilligan Will & Co. v. Securities and Exchange Commission, 267 F.2d 461, 466 (C.A. 2,), certiorari denied, 361 U.S. 896 (1959).

and other courts that have passed upon the question 22/ have consistently held "that the defendants have the burden of proving their affirmative defense of private offering." 23/ And this burden must be satisfied by "explicit, exact" evidence as to each and every offeree of the unregistered securities. Lively v. Hirschfeld, 440 F.2d 631, 633 (C.A. 10, 1971). 24/ Accord, Hill York Corp. v. American International Francises, supra, 448 F.2d at 691; Repass v. Ress, 174 F.Supp. 898, 904 (D. Colo., 1959). In addition, since the Securities Act "is remedial legislation entitled to a broad construction . . . its exemptions must be narrowly viewed." Hill York Corp. v. American International Francises, supra, 448 F.2d at 689. As pointed out, infra, Ernst & Ernst v. Hochfelder, ___ U.S. ___, 96 S.Ct. 1375 (1976), has not changed this general rule.

The district court properly found that Mr. Homans had failed to sustain his burden of establishing the availability of an exemption from the registration requirements of the Securities Act.

22/ E.g., United States v. Custer Channel Wing Corp., 376 F.2d 675 (C.A. 4), certiorari denied, 389 U.S. 850 (1967); Securities and Exchange Commission v. Van Horn, 371 F.2d 181 (C.A. 7, 1966); Securities and Exchange Commission v. Sunbeam Gold Mines, 95 F.2d 699 (C.A. 9, 1938).

23/ Hill York Corp. v. American International Francises, supra, 488 F.2d at 690. Mr. Homans argues (Br. 50) that this rule applies only where the issuer is asserting an exemption. As this Court has noted, however, the burden of proof is on the person claiming the benefit of an exemption, whether or not he is the issuer. Securities and Exchange Commission v. North American Research and Development Corp., 424 F.2d 63, 71-72 (C.A. 2, 1970); Gilligan, Will & Co. v. Securities and Exchange Commission, supra, 267 F.2d at 466.

24/ Mr. Homans accuses (Br. 17) the Commission of deception in including 1,106,050 shares of UMI common stock sold to 43 transferees in its overall figures, because those transactions reflected only the transfer of Mr. Ashbach's stock in UMI to Mr. Horsey and his "group." The Commission quite properly included these unregistered transfers and the burden was on Mr. Homans to establish that these particular transactions were eligible for the Section 4(2) exemption. The record does not show, however, who constituted the Horsey group and whether each of these individuals had access to information concerning UMI that a registration statement would contain or that each had the ability to "fend" for himself. Mr. Homans' label of "insider" does not satisfy his burden of proof.

Mr. Homans argues (Br. 44) that unless single transactions in securities are integrated there cannot be a "public offering" of securities and, therefore, the Section 4(2) exemption would apply. This argument assumes, however, that the number of offerees in a single offering is the determinative factor. But the Supreme Court has held that "the statute would seem to apply to a 'public offering' whether to few or many . . ." and suggested that "anything from two to infinity may serve: perhaps even one. . . ." Securities and Exchange Commission v. Ralston Purina Co., supra, 346 U.S. at 985 and n. 11. 25/ As the court below noted, the Ralston Purina case, and the cases which have followed it 26/ "make it crystal clear that it is not the manner in which a sale of unregistered securities is effected, but rather the class of persons to whom such securities are offered which determines whether the Section 4(2) exemption is available" (emphasis in original) (A. 162-163). While the integration of several offerings may be relevant to a determination of whether a public or private offering has taken place, such a finding is not, as Mr. Homans would have it, an essential ingredient of the calculus. 27/

25/ In the preliminary statement to Securities Act Rule 146, 17 CFR 230.146, the Commission reaffirmed its position that the availability of the Section 4(2) exemption "is not to be determined exclusively by the number of offerees."

26/ Securities and Exchange Commission v. Continental Tobacco Co. of South Carolina, supra, 463 F.2d 137; Lively v. Hirschfeld, 440 F.2d 631; Hill York Corporation v. American International Franchises, Inc., supra, 448 F.2d 680; Gilligan, Will & Co., supra, 267 F.2d 461.

27/ Mr. Homans makes much of the fact that the Commission has indicated what factors it considered in determining whether various offerings could be integrated (Br. 49). Securities Act Release No. 4434 (Dec. 6, 1961). See Securities Act Release No. 4552 (Nov. 4, 1962). These Commission pronouncements did not establish integration as a prerequisite, but only a factor for consideration.

Even if integration were a necessary element of a public offering, the facts show that the purportedly separate offerings of UMI's common stock, which ran continuously from March, 1967 through February, 1973, were part

(footnote continued)

The Section 4(2) exemption generally is available only where securities are offered to persons who have access to the kind of information about the issuer that a registration statement would disclose, 28/ and who are sophisticated so that they are able to "fend for themselves." 29/ As the court of appeals stated in Hill York, supra, 448 F.2d at 688, n. 6:

> "The definition of a class to which an offer of securities can be made in reliance on the private offering exemption may . . . be summarized as follows: where the number of offerees is so limited that they may constitute a class of persons having such a privileged relationship with the issuer that their present knowledge and facilities for acquiring information about the issuer would make registration unnecessary for their protection, then the exemption is available. Conversely, the term 'public offering' must refer to all offerings of securities where the public interest is not remote and the relationship between the issuer and offeree does not create special advantages in the offerees substantially different from the status of members of the public at large to be able to obtain all necessary information about the issuer and its securities . . . Certainly limiting the class of offerees does not invariably avail the person who claims the exemption. . . ." (emphasis added).

27/ (footnote continued)

of a single integrated plan (1) to acquire the fractional interests in the oil and gas properties which Duncan had sold to investors prior to 1966; (2) to service the interest obligations and convert UMI debentures into UMI common stock as a result of UMI's inability to pay the interest on debentures; and (3) to acquire monies to engage in the acquisition, exploration, development and production and sale of crude oil and natural gas.

28/ Securities and Exchange Commission v. Ralston Purina Co., supra, 346 U.S. 119; Gilligan, Will & Co. v. Securities and Exchange Commission, supra, 267 F.2d at 466.

29/ Securities and Exchange Commission v. Continental Tobacco Co. of South Carolina, supra, 463 F.2d at 137; Hill York v. American International Franchises, Inc., supra, 448 F.2d at 680.

While Mr. Homans asserts (Br. 13) that the "vast majority" of the transferees of unregistered UMI common stock were known to him as corporate "insiders," which he defines as officers, directors, accountants, attorneys, or family members and close associates of these persons, he concedes (Br. 47) that in at least 77 transactions he did not know the transferees, nor were they within the class of persons he described as insiders. 30/ Indeed, Mr. Homans did not even know how many offerees there were of UMI common stock, much less their identities or relationships to UMI, if any (A. 455).

The unsophistication of some of the transferees is evident from the testimony of Messrs. Nardone and Andersen, two investors in UMI. Neither of them had any particular relationship with UMI and they were not given access to the kind of information that would have been available in a registration statement. Mr. Homans authorized the transfer of UMI stock to them, see pp. 11-12, supra, even though in fact they were not "insiders" of UMI. At most, Mr. Andersen can be described as a friend of an insider; but that relationship is not sufficient to eliminate the protections that would have been available through registration.

Mr. Homans nonetheless claims (A. 100) that all transferees of UMI stock executed form letters indicating that they had received financial information concerning UMI and that they were acquiring the UMI stock for investment purposes and not for distribution. Thus, he suggests, transferees had access to the requisite

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30/ The district court found (A. 153), and Mr. Homans does not dispute, that he relied on the representations of UMI management as to the nature of the transferees of UMI stock.

information. Such investment letters often are only "bootstrap" recitals and "are only precautions . . . and are not to be regarded as a basis for exemption from registration." United States v. Custer Channel Wing Corp., supra, 376 F.2d at 679. The extent of the utility of such letters is reflected in the fact that Messrs. Nardone and Andersen executed such letters but testified that they really did not understand what they had signed (Tr. 54-55, 127-128).

Even if it were assumed that UMI provided offerees with all the information that registration would disclose, this would not suffice to establish the requisite relationship of those offerees to the company. The relationship must be such that each offeree has access to corporate information -- not because he has been the gratuitous recipient of information about an unfamiliar company, but because his position or connection with the company enables him to demand and receive first-hand all the relevant facts. As the Fifth Circuit emphasized in Hill York, supra, 448 F.2d at 688, n. 5:

> "[M]ere disclose of the same information as is required in a registration statement is not the alpha and the omega . . . '. . . this says too much if it implies that the exemption is assured, no matter what the circumstances, by giving each offeree the same information that would be contained in a registration statement though without the statutory safeguards and sanctions.' IV, Loss, Securities Regulation, 2632 (2d ed. Supp. 1969)."

"[T]he ultimate test [of the private offering exemption] is whether the 'particular class of persons affected need the protection of the Act.'" Hill York, supra, 448 F.2d at 689. Although disclosure of information is a relevant factor in determining the availability of a private offering exemption, such disclosure is unavailing when, as here, there was a total failure of proof as to the number of offerees and their relationsship to the issuer. Lively v. Hirschfeld, supra, 440 F.2d 631, 633.

II. LIABILITY FOR AIDING AND ABETTING VIOLATIONS OF SECTION 5 WAS IMPOSED ON MR. HOMANS FOR HIS KNOWING AND GROSSLY RECKLESS CONDUCT WHICH FACILITATED THE ILLEGAL DISTRIBUTION OF UNREGISTERED SECURITIES.

As described above, the district court held that Mr. Homans, as corporate counsel to UMI, aided and abetted the offer and sale of unregistered UMI securities through his issuance of opinion letters concerning the purported legality of those transactions under the federal securities laws. The court found that Mr. Homans, in some cases, knew, and in other cases, absent his gross recklessness, should have known that his opinions were being utilized to effect the illegal sale of unregistered securities (A. 172).

Mr. Homans argues (Br. 20) that the district court's decision must be reversed, even if its findings of fact were correct, because the federal securities laws do not authorize the imposition of secondary, rather than primary, liability on wrongdoers. Thus, he states (id.) that "there is no statutory or congressional authority for the theory of liability upon which the Commission's action against Mr. Homans and the opinion and judgment of the court below were based."

The concept of secondary liability for the violation of a statutory prescription is not a novel one. In Board of Trade of City of Chicago v. Price, 213 F. 336 (C.A. 8, 1914), the court of appeals affirmed the right of an individual to obtain an injunction against a person who knowingly aided and assisted in the conduct of a business that was contrary to the law. In the first case holding that secondary liability was appropriate

where there had been violations of the federal securities laws, the court discussed the criminal concept of treating one who aids and abets an unlawful act as equally responsible as the primary wrongdoer and held that "no good reason appears why this same rule should not apply in an injunctive proceeding to restrain a violation of the same statute." Securities and Exchange Commission v. Timetrust, 28 F.Supp. 34, 43 (N.D.Cal. 1939), reversed in part on other grounds, Timetrust v. Securities and Exchange Commission, 142 F.2d 474 (C.A. 9, 1944).

Since the Timetrust decision, this Court 31/ and other courts of appeal, 32/ as well as district courts, 33/ have recognized that in enforcement actions brought by the Commission and in private actions for damages, liability appropriately may be imposed on persons who aid and abet the securities laws violations of others.

31/ Securities and Exchange Commission v. Management Dynamics, Inc., 515 F.2d 801 (C.A. 2, 1975); Securities and Exchange Commission v. Spectrum, Ltd., 489 F.2d 535 (C.A. 2, 1973); Lanza v. Drexel & Co., 479 F.2d 1277 (C.A. 2, 1973); Securities and Exchange Commission v. North American Research & Development Corp., 424 F.2d 63 (C.A. 2, 1970).

32/ See, e.g., Rochez Brothers, Inc. v. Rhoades, 527 F.2d 880, 886 (C.A. 3, 1975); Woodward v. Metro Bank of Dallas, 522 F.2d 84, 94 (C.A. 5, 1975); Hochfelder v. Midwest Stock Exchange, Inc., 503 F.2d 364, 374-375 (C.A. 7), certiorari denied, 419 U.S. 875 (1974); Securities and Exchange Commission v. Coffey, 493 F.2d 1304, 1316 (C.A. 6, 1974), certiorari denied, 420 U.S. 908 (1975); Landy v. Federal Deposit Insurance Corp., 486 F.2d 139 (C.A. 3, 1973), certiorari denied, 416 U.S. 960 (1974); Securities and Exchange Commission v. National Bankers Life Insurance Co., 448 F.2d 652 (C.A. 5, 1971), affirming, 324 F.Supp. 189, 194 (N.D. Tex., 1971); Securities and Exchange Commission v. Barraco, 438 F.2d 97 (C.A. 10, 1971); Brennan v. Midwest Life Insurance Co., 417 F.2d 147, 151 (C.A. 7, 1969), certiorari denied, 397 U.S. 989 (1970).

33/ See, e.g., Securities and Exchange Commission v. National Student Marketing Corp., 402 F.Supp. 641, 648 (D.D.C., 1975); Odette v. Shearson, Hammill & Co., Inc., 394 F.Supp. 946, 960 (S.D.N.Y., 1975); Brown v. The Senex Corporation, [1975-1976 Transfer Binder] CCH Fed. Sec. L. Rep. ¶95,338 at p. 98,685 (E.D.Ky., Aug. 27, 1975); Securities and Exchange Commission v. Scott Taylor & Co., 183 F.Supp. 904, 909 (S.D.N.Y., 1959).

The rationale for the imposition of such liability was articulated by the court in Brennan v. Midwestern United Life Ins. Co., 259 F.Supp. 673, 680-681 (N.D. Ind., 1966), in the context of Section 10(b) and Rule 10b-5:

> "A basic philosophy of the Securities Exchange Act of 1934 is disclosure and is directed toward the creation and maintenance of a post-issuance securities market that is free from fraudulent practices. The investor's protection is the paramount consideration of much of the federal securities legislation and, in particular, of the 1934 Act here involved. The effect on an investor of an issuer corporation's failure to disclose improper activities of a brokerage firm dealing heavily in the issuer's stock, where the broker's activities create an appreciable risk of loss to tht investor, may be just as dangerous and equally as damaging as a failure by the issuer to disclose information of its own improper activities affecting the value of its stock. The loss to the investor may well be the same. This is not to say that there is no distinction between the two types of situations, but is rather to emphasize that a statute with a broad and remedial purpose such as the Securities Exchange Act of 1934 should not easily be rendered impotent to deal with new and unique situations within the scope of the evils intended to be eliminated. In the absence of a clear legislative expression to the contrary, the statute must be flexibly applied so as to implement its policies and purposes. In this regard, it cannnot be said that civil liability for damages so well established under the Securities Exchange Act of 1934, may never under any circumstances be imposed upon persons who do no more than aid and abet a vioiolation of Section 10(b) and Rule 10b-5."

The same considerations, we submit, apply in the case of Section 5 of the Securities Act, which reflects Congress' judgment that investors in securities, except under certain narrow circumstances, should receive the information that would be material to their investment decision.

In Securities and Exchange Commission v. Spectrum, Ltd., 489 F.2d 535 (C.A. 2, 1973), this Court considered the same conduct that is in issue in this case — an attorney's opinion letters that were used in connection with

the sale of unregistered securities. There Chief Judge Kaufmann noted that although the attorney may not have been involved in the sale of unregistered securities as an underwriter, "he could be liable, nevertheless, as an aider and abetter to . . . [the] illicit venture." Id. at 541. The Court then fashioned the standard by which it believed such liability must be measured:

> "In assessing liability as an aider and abettor, however, the district judge formulated a requisite standard of culpability -- actual knowledge of the improper scheme plus an intent to further that scheme -- which we find to be a sharp and unjustified departure from the negligence standard which we have repeatedly held to be sufficient in the context of enforcement proceedings seeking equitable or prophylactic relief.
>
> We do not believe, moreover, that imposition of a negligence standard with respect to the conduct of a secondary participant is overly strict, at least in the context of this case. The legal profession plays a unique and pivotal role in the effective implementation of the securities laws. Questions of compliance with the intricate provisions of these statutes are ever present and the smooth functioning of the securities markets will be seriously disturbed if the public cannot rely on the expertise proffered by an attorney when he renders an opinion on such matters." Id. at 541-42 (citations omitted).

In adopting this approach, the Court rejected the suggestion of one commentator 34/ that imposing a duty on an attorney to investigate the activities of his client would place an undue burden on the professional.

> "In the distribution of unregistered securities, the preparation of an opinion letter is too essential and the reliance of the public too high to permit due diligence to be cast aside in the name of convenience. The public trust demands more of its legal advisers than 'customary' activities which prove to be careless." 489 F.2d at 542.

34/ Ruder, Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delecto, Indemnification and Contribution, 120 U. Pa. L. Rev. 597, 632-633 (1972).

The standard in Spectrum was clarified in Securities and Exchange Commission v. Management Dynamics, Inc., supra, 515 F.2d at 811:

> "In Spectrum we ruled that the liability of a lawyer as an aider and abettor was to be measured by the negligence standard applicable to SEC injunction actions and the high degree of carelessness present there.
>
> * * *
>
> The crucial element of our ruling in Spectrum was that the abettor's responsibility for the alleged violation must be measured by the appropriate standard of negligence, that is, the defendant should have been able to conclude that his act was likely to be used in furtherance of illegal activity."

It is clear that aiding and abetting liability can be imposed where the individual knew that his actions were in furtherance of an illegal activity, or, based on the facts, he "should have been able to conclude" that his actions were in furtherance of such an activity. In this case, the district court found that Mr. Homans, in some instances, knew that his opinions would be used to facilitate the sale of unregistered securities, and in other instances, he was grossly reckless in relying on the representations of UMI management and in failing to make any effort to ensure that all of the offerees of unregistered UMI common stock were within the class of persons that appropriately would be within the scope of the Section 4(2) exemption. Thus the court stated:

> "Homans had direct knowledge of the fact that his client was engaged in an illegal distribution of common stock upon conversion of the 6% debentures and for interest upon those debentures. His refusal to issue an opinion to Continental without the submission of a second opinion by Gedalecia

> in those instances points ineluctably to the conclusion that he knew that his opinion would be used to further these illegal distributions. . . . In view of the notice he had as of late 1967 or early 1968 as to the inherent problem of relying upon his client and Gedalecia, it was reckless for him not to have looked behind the representations before directing that Continental transfer the stock in question." (A 172).

Mr. Homans does not challenge these findings; he argues simply (Br. 28) that had Congress "wished in Section 5 to make unlawful not only 'selling' but also aiding and assisting an unlawful sale, it would have said so." 35/ The failure of Congress, however, to include specific language in the statute authorizing the imposition of secondary liability does not establish the converse — that Congress intended to restrict liability. 36/ As the Supreme Court stated in Helvering v. Hallock, 309 U.S. 106, 119-121 (1970):

> "To explain the cause of non-action by Congress when Congress itself sheds no light is to venture into speculative unrealities . . . Various considerations of parlimentary tactics and strategy might be suggested as reasons for the inaction . . . of Congress, but they would only be sufficient to indicate that we walk on quicksand when we try to find in the absence of corrective legislation a controlling legal principle."

35/ Mr. Homans recognizes, however, that Section 5, as drafted, would cover criminal aiding and abetting liability (Br. 26). He argues, however, that the exact same statutory language is not enough to impose civil liability for aiding or abetting Section 5 violations.

36/ Nor was the failure of Congress in the late 1950's and early 1960's to enact amendments to the securities laws suggested by the Commission that would have clarified the liability that could be imposed for aiding and abetting, particularly significant. "It is often difficult to determine Congressional intent from positive actions of Congress, but it is impossible to determine such intent from a failure of Congress to act." Brennan v. Midwestern United Life Insurance Co., supra, 259 F.Supp. at 673.

If anything, Congress' failure to restrict such liability after it had become well established in the courts, suggests acquiescence in the courts' interpretation. Cf. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

Mr. Homans argues (Br 20-21) that in its recent decision in Ernst & Ernst v. Hochfelder, supra, 96 S.Ct. 1375, the Supreme Court expressed some "doubt" as to whether secondary liability could be imposed under Section 10(b) and Rule 10b-5. The Court, however, stated:

> "In view of our holding that an intent to deceive, manipulate, or defraud is required for civil liability under §10(b) and Rule 10b-5, we need not consider whether civil liability for aiding and abetting is appropriate under the section and the rule. . . ." 96 S.Ct. at 1380, n. 7.

It is clear that the Court was not expressing any view on aiding and abetting liability.

Mr. Homans also argues (Br. 34-35) that, even if aiding-and-abetting liability can be imposed for Section 5 violations, it is applicable only where a defendant has been shown to have acted with an intent to deceive, manipulate, or defraud. In finding Mr. Homans liable as an aider and abettor the district court relied upon the negligence standard articulated by this Court in the Spectrum and Management Dynamics cases. Mr. Homans asserts (Br. 34) that, in light of the Supreme Court's decision in Ernst & Ernst, those cases "must be overruled and rewritten to conform to the Supreme Court's holding. . . ."

In Ernst & Ernst, which was a private action seeking damages for violations of the antifraud provisions of Section 10(b) and Rule 10b-5, the Supreme Court analyzed the language of Section 10(b) and concluded that it indicated that Congress intended to proscribe conduct that was more than

simply negligent — it applies to conduct where some form of "scienter" can be attributed to the actor. While the Court defined scienter to be a "mental state embracing an intent to deceive, manipulate, or defraud . . .," it indicated also that "[in] certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act." 96 S.Ct. at 1381, n. 12.

Whatever may be the scope of the scienter requirement enunciated in Ernst & Ernst, 37/ in an action involving Section 10(b) and Rule 10b-5, it has no application in an action involving Section 5. While the actor's state of mind is an essential consideration in determining whether he had violated the antifraud rules, violations of the registration provisions in Section 5 do not require an inquiry into the state of mind of the person charged. Mr. Homans points up the difference between these provisions very succinctly (Br. 25):

> "Section 5 differs from Section 10(b) of the Exchange Act and Section 17 of the Securities Act in that they are so-called 'fraud' statutes, whereas Section 5 is is a strict liability statute in the sense that a violation may exist without any element of fraud or deception being involved."

37/ The Court did not reach the question of whether the scienter requirement is applicable in Commission actions seeking prophylactic relief in the public interest for violations of antifraud provisions. 96 S.Ct. at 1381, n. 12. This Court has repeatedly indicated that there may be a lesser showing by the Commission to obtain injunctive relief than is required in private actions. Securities and Exchange Commission v. Management Dynamics, Inc., supra, 515 F.2d at 801; Securities and Exchange Commission v. Spectrum, Ltd., supra, 489 F.2d at 541; Lanza v. Drexel & Co., supra, 479 F.2d at 1304; Securities and Exchange Commission v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1096 n. 15 (C.A. 2, 1972); and Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F.2d 833, 868(C.A. 2, 1968) (Friendly, J., concurring), certiorari denied, 394 U.S. 976 (1969).

Consistent with Mr. Homans analysis of the nature of Section 5, the court in Securities and Exchange Commission v. National Bankers Life Insurance Co., 324 F.Supp. 189, 194 (N.D. Tex., 1971) stated:

> "No intent is required to violate Section 5 as an aider and abettor and the only knowledge requirement is that a defendant had reason to know or should have known that the securities should have been registered" (citation omitted).

It should also be noted that the Court in Ernst & Ernst nowhere purports to limit its previous diecisions to the effect that the securities laws must be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes." Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1971); Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971); Securities and Exchange Commission v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963).

Even if the scienter requirement articulated by the Supreme Court in Ernst & Ernst did apply to violations of Section 5, Mr. Homans' conduct clearly would satisfy it. The district court found that Mr. Homans knew that his letters were being used in the sale of unregistered stock; he also was found to have been reckless in his dependence on others and his failure to conduct even an elemental inquiry into facts that were relevant to his opinions. Mr. Homans' conduct is analogous to that of the accountants in Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, [Current] CCH Fed. Sec. L. Rep. ¶95,660 (C.A. 2, July 15, 1976), which this Court held had satisfied the scienter requirement of Ernst & Ernst. As this Court noted in that case:

> "The accountants here are not being cast in damages for negligent nonfeasance or misfeasance, but because of their active participation in the preparation and issuance of false and materially misleading accounting reports on which Herzfeld relied to his damage." 38/

38/ This distinction between knowing action and negligence also was drawn by the Court of Appeals for the Ninth Circuit in an order denying rehearing in United States v. Charnay, [1975-1976 Transfer Binder] CCH Fed. Sec. L.

(footnote continued)

III. THE DISTRICT COURT DID NOT ABUSE ITS DISCRETION IN ENJOINING MR. HOMANS FROM PARTICIPATING IN FURTHER VIOLATIONS OF THE REGISTRATION PROVISIONS OF THE SECURITIES ACT OF 1933.

In Securities and Exchange Commission v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1100 (C.A. 2, 1972) this Court noted:

> "In an action . . . , where the SEC sought injunctive relief . . ., a district court has broad discretion to enjoin possible future violations of law where past violations have been shown and the court's determination that the public interest requires the imposition of a permanent restraint should not be disturbed on appeal unless there has been a clear abuse of discretion" (citations omitted).

The Court noted that the burden is on the party seeking to overturn the district court's exercise of discretion, and the burden "necessarily is a heavy one." Id. 39/ Here the record fully supports the district court's conclusion that the issuance of a permanent injunction was appropriate; Mr. Homans has failed to establish that the district court abused its discretion in granting such relief.

38/ (footnote continued)

Rep. ¶95,560 (May 7, 1976), petition for rehearing en banc denied (July 8, 1976), petition for certiorari filed, 45 U.S.L.W. 3178 (U.S. Sept. 7, 1976) (No. 76-356). There, in a case which sustained a criminal indictment for violations of Section 10(b) and Rule 10b-5, the court of appeals held consistent with Hochfelder its ruling that it was necessary for the prosecution to show only an intentional act with "a realization on the defendant's part that he was doing a wrongful act." Slip op. at 3. Similarly, the court observed that one of the panel judges in his concurring opinion had noted that "the intent necessary . . . is merely that of intending to do the acts prohibited, rather than intent to violate the statute." Id.

Accord Bailey v. Meister Brau, Inc., [1975-1976 Transfer Binder] CCH Fed. Sec. L. Rep. ¶95,543 at p. 99,735 & n. 14 (C.A. 7, May 6, 1976).

39/ Accord, United States v. W. T. Grant Co., 345 U.S. 629, 633 (1973); Securities and Exchange Commission v. Culpepper, supra, 270 F.2d at 250.

The standards governing the issuance of an injunction sought by the Commission for the protection of the public are free from the more restrictive criteria applicable in private litigation. Securities and Exchange Commission v. Management Dynamics, Inc., supra, 515 F.2d 808. 40/ As the Supreme Court has stated, "the standards of the public interest, not the requirements of private litigation, measure the propriety and need for injunctive relief in these cases." Hecht Co. v. Bowles, 321 U.S. 321, 331 (1944). In Securities and Exchange Commission v. Manor Nursing Centers, supra, 458 F.2d at 1100, this Court noted that "the critical question for a district court in deciding whether to issue a permanent injunction in view of past violations is whether there is a reasonable likelihold that the wrong will be repeated." 41/ The fact that a defendant has ceased his illegal activities prior to the institution of any action by the Commission will not preclude the entry of injunctive relief. United States v. Parke-Davis & Co., 362 U.S. 29, 48 (1960); Securities and Exchange Commission v. Keller Corp., 323 F.2d 397 (C.A. 7, 1963); Securities and Exchange Commission v. Boren, 283 F.2d 312, 313 (C.A. 2, 1960).

40/ As stated in Mitchell v. Pidcock, 299 F.2d 281, 287 (C.A. 5, 1962):

> "We do not say or imply that injunctions should be issued freely, without regard for the facts, simply because it is the Government asking for the injunction. We say that the manifest difficulty of the Government's inspecting, investigating, and litigating every complaint of a violation weighs heavily in favor of enforcement by injunction — after the court has found an unquestionable violation of the Act."

41/ Accord, Securities and Exchange Commission v. Management Dynamics, supra, 515 F.2d at 807; Securities and Exchange Commission v. Kalvex, Inc., [1975-1976 Transfer Binder] CCH Fed. Sec. L. Rep. ¶95,226 (S.D.N.Y., 1975).

Several factors are particularly relevant in determining whether or not there exists a reasonable likelihood of future violations. The courts, for example, have pointed out that such a likelihood may be inferred from past violations 42/ or from the fact that a defendant continues to maintain that his conduct was appropriate. 43/ In Securities and Exchange Commission v. First American Bank & Trust Company, 481 F.2d 673, 682 (C.A. 8, 1973), the court of appeals, in discussing the inference that past wrongs may give rise to the expectation of future misconduct, stated that the "inference is even stronger when the wrongdoers insist that their actions are legitimate and do not violate the Act."

In this case, Mr. Homans engaged in gross violations of the registration provision over an extended period of time. He maintains that his conduct was legal and proper and that no violations of the securities laws existed. As discussed above, pp. 14-16, supra, the district court's findings as to violations of the registration requirements are fully supported in the record. Moreover, Mr. Homans' role in those violations is direct and substantial -- he knew that his opinion letters were being used in connection with the sale

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42/ Securities and Exchange Commission v. Management Dynamics, Inc., supra, 515 F.2d at 807: Securities and Exchange Commission v. Shapiro, 494 F.2d 1301, 1308 (C.A. 2, 1974); Securities and Exchange Commission v. First American Bank & Trust Co., supra, 481 F.2d at 682; Securities and Exchange Commission v. Manor Nursing Centers, Inc., supra, 458 F.2d at 1100; Securities and Exchange Commission v. Keller Corp., supra, 323 F.2d at 402; Securities and Exchange Commission v. Culpepper, supra, 270 F.2d at 249-250; Securities and Exchange Commission v. J & B Industries, Inc., 388 F.Supp. 1082, 1084 (D. Mass., 1974); Securities and Exchange Commission, v. M. A. Lundy Associates, 362 F.Supp. 226, 232 (D.R.I., 1973).

43/ Securities and Exchange Commission v. First American Bank & Trust Company, supra, 481 F.2d at 632; Securities and Exchange Commission v. Manor Nursing Centers, Inc., supra, 458 F.2d at 1101; Securities and Exchange Commission v. MacElvain, 417 F.2d 1134, 1137 (C.A. 5, 1969), certiorari denied, 397 U.S. 972 (1970).

of unregistered securities and was grossly reckless in not investigating the facts underlying certain other transactions. 44/ Under these circumstances -- particularly the facts that Mr. Homans apparently still does not appreciate the scope of the registration requirements and that he intends to render advice on securities law matters to public companies in the future — more than justifies the district court's conclusion that a permanent injunction was necessary to protect the public interest.

Mr. Homans argues that the district court should have accepted his proposals that the injunction be limited as to time and that during that period, he would submit all securities law opinions he rendered to the Commission for review and establish other procedures to avoid violations in the future. Mr. Homans suggests that making these proposals indicates that there is no reasonable likelihood that he would violate the federal securities laws in the future. Under the circumstances, he posits that a broader injunction, such as entered by the district court, was beyond remedial relief and constituted a penalty for his past violations.

The district court considered Mr. Homans' proposals but rejected them since, in the court's view, they would have placee unjustified burdens on the court and the Commission to police the terms of the order. This Court in

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44/ In Securities and Exchange Commission v. Mono-Kearsarge Consol. Mining Co., 167 F.Supp. 248, 261 (D. Utah, 1958), the court stated that it

> "may infer from a wanton or even careless willingness to take a chance on the legality of questionable transactions that a defendant is about to similarly violate the Act if afforded an opportunity to do so in the absence of an injunction.

Securities and Exchange Commission v. Culpepper, supra, 270 F.2d at 250, recognized the difficulties in such an approach and approved injunctive relief as the more desirable alternative. 45/

In view of the pivotal role played by lawyers in the securities area, it is of the utmost importance that the courts issue injunctions against the careless, the incompetent and the venal practitioners whose mistakes or transgressions can seriously injure the investing public. This is not a case of a single isolated mistake or transgression by a securities lawyer, but rather a situation demonstrative of an attorney's repeated disregard for the requirements of the securities laws which clearly warranted the issuance of an injunction to protect the public interest. 46/ As this Court stated

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45/ See also Securities and Exchange Commission v. Graye, 156 F.Supp. 544, 547 (S.D.N.Y., 1957), where Judge Kaufman stated:

> "I fail to see any injury resulting to defendant by the granting of this injunction. As was stated in Securities and Exchange Commission v. Otis, D.C. Ohio, 1936, 18 F.Supp. 100, 101, affirmed, Otis v. Securities and Exchange Commission, C.A. 6, 1939, ___ F.2d 579: 'If in fact defendant has no intention of again offending, it will not be injured by an injunction.' The injunction does not seek to put defendant out of business. It seeks only to restrain him from doing business while he is in violation of the S.E.C. rules. It does not seek to harm defendant, but rather to protect the public compliance will mean continuation."

46/ Having considered the impact of injunctive relief on the defendant, Judge Tenney's decision to enjoin the defendant was not an "unreasonable one" for "[t]he public interest, when in conflict with private interest, is paramount." Securities and Exchange Commission v. Culpepper, supra, 270 F.2d at 250.

in United States v. Benjamin, 328 F.2d 854, 863 (C.A. 2, 1964), with respect to the criminal liability of lawyers and other professionals:

> "In our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar. . . . Congress . . . could not have intended that men holding themselves out as members of these ancient professions should be able to escape criminal liabiilty on a plea of ignorance when they have shut their eyes to what was plainly to be seen or have represented a knowledge they knew they did not possess."

CONCLUSION

For the foregoing reasons, the order of the district court should be affirmed.

Respectfully submitted,

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Securities and Exchange Commission
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Dated: September 1976

STATUTORY APPENDIX

Section 4(2) of the Securities Act of 1933, 15 U.S.C. 77d(2)

SEC. 4. The provisions of section 5 shall not apply to—
(2) transactions by an issuer not involving any public offering.

Section 5(a) of the Securities Act of 1933, 15 U.S.C. 77e(a)

SEC. 5. (a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF THE
GENERAL COUNSEL

September 20, 1976

A. Daniel Fusaro, Esquire
Clerk, United States Court of
Appeals for the Second Circuit
United States Courthouse
Foley Square
New York, New York 10007

Re: Securities and Exchange Commission v. Arthur J. Homans,
No. 75-6111

Dear Mr. Fusaro:

Enclosed for filing with the Court are ~~twenty-five~~ ten copies of the Brief of the Securities and Exchange Commission, Appellee, in the above-capitioned matter.

I hereby certify that I am a member of the Bar of this Court and have caused copies of the foregoing to be mailed, postage prepaid, to counsel for petitioner.

Sincerely,

Howard B. Scherer

Howard B. Scherer
Attorney

Enclosures

P.S. We are retaining the other 15 copies pursuant to your memorandum of January 20, 1976.